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Inside

Fraud Hotlines: Early Warning Systems

Interest in fraud hotlines has surged since passage of the Sarbanes-Oxley Act and its requirement that public company employees be able to confidentially and anonymously report questionable accounting or auditing matters. Private companies, however, may also benefit from establishing similar warning systems. Here are some tips for selecting and operating an effective system.

The Sarbanes-Oxley Act of 2002 (the Act) requires every publicly traded company "to establish procedures for the receipt, retention and treatment of complaints . . . regarding internal accounting controls or auditing matters." Section 301 of the Act requires the audit committee to establish a procedure for employees to report—anonymously and confidentially—their concerns about these matters. The Securities and Exchange Commission (SEC) has issued a final rule requiring compliance by the first annual shareholders' meeting after January 15, 2004, but no later than October 31, 2004. Failure to comply results in the company's being delisted by the stock exchange or securities association through which its stock is traded.

This new requirement has revived interest in fraud hotlines, mostly telephone systems and Web-based tools, used to field employee allegations and complaints. Many companies established such hotlines as part of company-wide corporate ethics programs in response to the Federal Sentencing Guidelines enacted in 1991 by the U.S. Sentencing Commission. According to the guidelines, the Commission can impose severe financial penalties on an entity convicted of corrupt and unethical business practices. Liability and fines can be significantly reduced, however, if the company has an effective mechanism for reporting wrongdoing, including a system "designed to detect criminal conduct by others within the organization without fear of retribution."

Private company needs

Public companies are not alone in the need to establish complaint procedures as part of an effective internal control structure. Any organization with 50 or more employees is subject to the Federal Sentencing Guidelines. Small businesses can also benefit from establishing a mechanism for the reporting of wrongdoing. The vulnerability of small entities is evident, according to William S. Laufer, Associate Professor of Legal Studies, the Wharton School, in statistics showing that, of all corporations convicted of unethical business practices in federal courts, more than 90% are small businesses and more than 95% are privately held.

In 2000, 72% of the companies prosecuted in federal courts were ordered to pay fines, according to the U. S. Sentencing Commission. The average fine was almost $1.6 million and legal costs were additional. In 2001, the fines of 186 organizations averaged $2.2 million each. None of the organizations received a reduction in fines because they did not have an "effective program to prevent and detect violations of law" in place.

All companies, public or private, large or small, can benefit from establishing a system and fostering a culture that will help prevent, detect, and address not only auditing and accounting irregularities, but also other fraud or wrongdoing, such as bid rigging, corruption and bribery, and collusion and theft (for example, skimming revenues, fraudulent disbursements, stolen inventory).

A silver lining?

Legislators believe that the Sarbanes-Oxley Act addresses the need to protect investors from public companies' misleading financial statements issued at the behest of corporate executives, sometimes with the assistance of external auditors. Relentless media attention, along with Congressional actions, has created the impression that the wrongdoing is widespread. On the other hand, media attention has also made many employees aware of the ramifications of such misconduct. The well-publicized spectacle of Enron employees losing their life savings because of senior managers' misconduct vividly shows all employees the harm that can arise from indifference to the wrongdoing of others. Fraud and other misconduct can erode profits and retirement funds, and can even eliminate jobs.

A warning system that supports whistleblowers, such as a fraud hotline, encourages employees to act when others do wrong. It can inspire confidence in employees that reporting misconduct is in their best interest and will benefit them, other employees, and the company. It helps to create a culture that values ethical behavior, is committed to preventing and detecting fraud, and will respond decisively and appropriately to misconduct.

In addition to fielding tips about possible fraudulent activity, and sending the message to employees that helps to prevent and detect fraud, hotlines also play a role in ensuring that management can effectively address other illegal and unethical employee behavior such as discrimination and harassment.

In addition to incurring the financial benefits of early detection of fraud and limiting liability related to such offenses as harassment and discrimination, the hotline offers company management the opportunity to uncover and address issues before they are exposed by the media, thereby protecting the company from the additional loss of goodwill in the eyes of its customers, investors, and other stakeholders.

Selecting a system

As noted earlier, systems to allow the reporting of fraud have been in place in many organizations for several years. Some systems have been internal firm-operated programs; others are operated by vendors. Since the enactment of the Sarbanes-Oxley Act, existing vendors have significantly increased their client base and new vendors have proliferated to take advantage of the market opportunities. In response to the U.S. Sentencing Commission incentives to encourage companies to establish corporate ethics programs, many companies set up various methods of providing employees an opportunity to report wrongdoing. Some companies established the position of chief ethics officer to oversee the corporate program. Others appointed ombudsmen to address complaints and allegations of wrongdoing. Hotlines were established too.

At minimum, a hotline is an answering machine that records messages to be played back by company personnel or call forwarding systems that send calls to an in-house department. Resource limitations, however, may deter some small firms and privately held firms from having compliance programs. Practitioners should remember that these limitations also increase their vulnerability. Small firms particularly tend to be less formal in structure, culture, and means of communication and less likely to have formal training, documentation, and standards. They also tend to be more focused on customer satisfaction than on compliance.

The hotline services that sprouted up in response to Sarbanes-Oxley requirements are generally toll-free phone lines operating 24 hours a day, 7 days a week, 365 days a year. With many new players in the field, the need for caution in purchasing their services goes without saying. Recently, the *Wall Street Journal* reported the cautionary comment of Roger Raber, president and CEO of the National Association of Corporate Directors, Washington, DC, who said, "Nine out of 10 are new people that don't have a track record or a client base"

Several factors are key to effective operation of hotlines:

- ***Around-the-clock availability.*** Most employees and other tipsters are unlikely to call during working hours to report illegal activity. According to hotline studies, at least 40% of calls come at night or on weekends. An unanswered call will probably discourage the tipster from calling again. A caller is likely to be at least nervous and may even feel threatened, so it's preferable to have a trained interviewer answer calls. A nervous tipster may leave out significant details. A trained interviewer should know what questions to ask to ensure that the company gets enough information to investigate the allegation.

Letters to the Editor

The Practicing CPA **encourages readers to write letters on practice management and on published articles. Please remember to include your name and telephone and fax numbers. Send your letters by e-mail to pcpa@aicpa.org.**

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- *Anonymity and confidentiality.* Employees probably will be uncomfortable calling an internal number or reporting their allegation to an employee, who may recognize their voice or identify the caller because of some telling detail in the allegation. Confidentiality must be preserved and the caller must be protected against possible retaliation. (Sections 806 and 1107 of the Sarbanes-Oxley Act provide whistleblower protections. See the sidebar on this page.)
- *Case management system.* To ensure that complaints and allegations are tracked and addressed, a database of original reports will allow the hotline administrator (and when appropriate, the audit committee) to review reports. The data captured should include what was done to investigate the allegation, the final disposition, and the disciplinary or corrective actions taken. The Sarbanes-Oxley Act requires that public companies have a case management system whereby the audit committee is notified of allegations of insider trading, improper loans to executives, retaliation against whistleblowers, conflicts of interest, and accounting irregularities. Incident reports of such wrongdoing related to senior executives should be routed automatically to one or more audit committee members to help ensure that they reach the board and are not intercepted or covered up.

Launching a hotline

Like any new initiative, launching a hotline requires an effective communication program. The first step is for senior management to announce the goals of having the hotline program and the reason for implementing it. In a public company, the goal would be to give employees every opportunity to communicate to the company and to the board of directors. Every employee should receive a letter or flyer announcing the program, along with a business card with the hotline phone number. Employees should be introduced to the program in meetings, and posters around their work areas should reinforce the messages they've been given. New employees should receive this information as part of their orientation.

The company should document that employees have received information about the hotline and understand it. To avoid abuse of the hotline, for example, employees calling to complain about an "unfair" review or the cafeteria menu, the communication program needs to make clear the hotline's purpose, as well as the appropriate mechanisms for addressing complaints if no wrongdoing is involved.

Finally, in planning an implementation program for this initiative, remember the guidance offered by Dominic Cingoranelli in the October issue of *Practicing CPA* (see "Communicating Change Initiatives"): ". . . repetition is not only all right, but also a must."

Complaint Procedure

In Section 301 Public Company Audit Committees.

(4) Complaints.-Each audit committee shall establish procedures for:

(A) the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and

(B) the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters.

Protecting Whistleblowers

Whistleblowers who report questionable accounting or auditing practices are protected by:

- **Section 806, which gives employees the right to sue their employer for retaliation. Employees must file a charge with the U.S. Department of Labor. OSHA then has 180 days to investigate and resolve the complaint. If whistleblowers are not satisfied with the resolution, they can sue.**
- **Section 1107, which provides for criminal penalties for retaliation, including up to ten years in prison.**

Skill-Sharpening Opportunities

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By David W. Cottle, CPA, CMC

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Where to Find Fraud in Closely Held Companies

Privately held firms and public companies may have different incentives to perpetrate fraud, although the methods used are similar. Here's some guidance on why fraud may occur in a private company, where to look for it, and how to help prevent it. The following article is adapted from Financial Reporting Fraud: A Practical Guide to Detection and Internal Control *by Charles R. Lundelius, Jr., CPA/ABV (New York: AICPA, 2003).*

Closely held private companies and public companies are equally likely to experience fraud; only the motives and timing are slightly different. The management of closely held companies might not have to worry about securities analysts' expectations, but outside shareholders, bankers, and venture capitalists may demand better earnings performance. These demands can lead management to employ any of the earnings manipulation schemes used by public companies. Of course, if management bonuses are a function of increased earnings, there is a motive for earnings manipulation regardless of whether the company is publicly traded. The timing of these pressures may differ from that of public companies, though. If the outside investors are passive, the moment of performance assessment for management will most likely be the end of the fiscal year. Management of public companies, on the other hand, may feel pressure to hit targets quarterly, if they have to publish their financial statements. Regardless of whether the pressures come annually or quarterly, the motives for fraud exist.

The flip side of earnings manipulation that improperly creates additional income for financial reporting purposes is earnings manipulation that improperly lowers income for tax reporting purposes–tax fraud. To achieve this result, the manipulator may operate with two sets of books that do not reconcile; one for investors and bankers and one for the tax authorities. Most companies, of course, maintain separate tax-basis books that allow them to determine tax gains and losses from asset dispositions, for instance. The difference between the fraudster's tax books and legitimate tax books is that the fraudster's books may not reconcile to the financial reporting books through legal reconciling entries. For example, through revenues parked off-shore in a tax haven or the use of related entities, costs can be shifted from low-tax rate to high-tax rate affiliates.

Placating outside shareholders

The shareholders of private companies who are not part of management may find themselves in the minority. The founders of the company usually serve in management positions, and, if the need to raise capital is not so great as to force the company to turn to venture capitalists, the founders and key managers can retain control as they sell shares to outsiders.

Minority outsiders can make demands on management even if they have been outvoted by the insiders. State laws generally protect minority shareholders if the majority owners attempt to implement a financial or share distribution plan that favors the majority over the minority. Setting up a stock bonus plan for management, for instance, may require minority shareholder approval. To obtain approval, management may attempt to placate minority shareholders' concerns by demonstrating strong financial performance, and if actual firm performance is lacking, management may seek to dress up the income statement with some earnings manipulation.

Satisfying banker lenders

For the closely held firm, the bank is the typical source of debt financing. If bankers make loans, they generally tie covenants in the debt instrument to a firm's balance sheet to provide some assurance that available assets will be sufficient to collect on the loan in the event of default. For instance, the covenants may require the firm to maintain a maximum debt-to-equity ratio and a minimum amount of shareholders' equity. The covenants also define the events that cause a default, and balance-sheet accounts may be a part of the numerical and ratio tests imposed by the bank to determine whether the firm has suffered a "material adverse change" that would allow the bank to call the loan due and foreclose if necessary.

In addition, for revolving credit facilities that allow for periodic borrowing, repayment, and borrowing again, banks usually establish a borrowing base. That base is a calculated dollar amount that is usually a percentage of receivables and inventory. The firm, then, may borrow up to the amount of the base, but no more, effectively limiting the use of the bank's funds to financing current assets.

The motives for and methods of balance-sheet fraud on lenders apply to the closely held company as well as public companies. However, in light of the importance of bank financing to the closely held company, the CPA should be especially aware of the potential for fraud in this context. The motives for private firm management to manipulate the balance sheet to avoid a cutoff of bank financing are especially strong because alternative sources may not be readily or cheaply available. Therefore, the CPA should watch carefully those accounts (usually balance-sheet items) that are used in the tests imposed by the bank.

Also, the CPA should keep in mind that there is a potential for fraud not just to avoid a material adverse change or default event, but also to improperly expand the borrowing base. For example, the borrowing base calculation may be set at 80% of accounts receivable, but only those receivables outstanding for less than 90 days are counted. If the firm receives partial payment from a customer for a recent bill, the firm may apply that payment to an older bill–say, past 90-days–to keep the recent bill in the borrowing base. Likewise, the firm may attempt to cancel old bills and reissue them just to keep a larger balance in the under-90-days category. Therefore, the CPA needs to pay special attention to the activity within accounts receivable when receivables are part of the borrowing base.

Pressure to go public

If the private firm is funded by venture capital, pressure to perform can be enormous. For instance, venture capitalists (VCs) in high technology ventures generally look to cash out of their investments within three to five years, earning an annualized rate of return in excess of 40 percent over their entire portfolio of early stage companies. However, the VCs also expect that most of the firms they back will fail, a few will break even, and only about 10 percent to 20 percent will succeed. For those companies lucky enough to succeed, the VCs expect annualized rates of return of about 100 percent or more to make up for the losses sustained in firms that did not succeed.

By Charles L. Lundelius, CPA/ABV

The exit plan for most venture capitalists is usually an initial public offering (IPO) of stock to be publicly traded. Part of the shares offered to the investing public consists of those shares held by the VCs. The IPO market is fickle, and favorable conditions come and go. Therefore, if an IPO window opens, investment bankers may join with the VCs to push firm management to go public regardless of the firm's financial position.

The CPA must be especially alert when looking at the books and records of firms planning to go public. Because of the strict liability standards imposed by the Securities Act of 1933, if management attempts to manipulate financial data, the manipulation will be most carefully hidden. In all likelihood, any manipulation would be effected by indirect methods, making full use of accounting gray areas. In particular, the CPA should watch out for changes in accounting methodology made by management just before the IPO to improve reported earnings.

Tax incentives

One of the most common uses of financial information from private companies is for income tax reporting purposes, and most taxable entities will strive to reduce reported income to minimize income taxes. Firms can and do maintain separate records for book and tax reporting with the objective of reporting as much income in the former and as little income in the latter as possible. Firms can legally lower taxable income to levels well below generally accepted accounting principles (GAAP) basis net income through a number of allowable exclusions, deductions, and accelerated write-offs. For example, if a firm sells assets at a gain on an installment-sale basis under which the seller will receive payments over a period of years, that firm can defer recognizing a portion of the gain until future tax periods for income tax purposes (Internal Revenue Code [IRC] Sec. 453(c)). Under GAAP, the gain is recognized entirely in the year of sale.

However, the corporate alternative minimum tax imposed on earnings and profits through the adjusted current earnings (ACE) mechanism (IRC Sec. 56(c)(1) and 56(g)) has reduced, to some extent, the perceived advantage of using two sets of books. The ACE adjustment was designed to bring alternative minimum taxable income to a level closer to book-basis net income. Gains from installment sales, for instance, are recognized in the year of sale under ACE, just as they are under GAAP.

To achieve income minimization as a tax reduction strategy, then, a private firm may be willing to take on expenses that should otherwise be shared with other related parties, including owners. Conversely, a firm that has significant net operating loss carryforwards (NOLs) for tax purposes may be willing to absorb income from other related parties. For example, assume two firms are under common ownership, and one firm, a manufacturer, makes products used by the second firm, its customer. The manufacturer, though, has a sizable NOL from prior tax years. The related-party customer, wishing to minimize its taxes, may allow the manufacturer to mark up the price of products it sells so the manufacturer reports more income to use up its NOL carryforward. The (illicit) markup, then, has the effect of increasing the customer's inventory cost that, eventually, reduces its income and its taxes, while not causing the manufacturer to pay any current period tax. Aside from being subject to penalties and other measures for tax fraud (under IRC Sec. 6663), the manufacturer's and the customer's GAAP basis books are fraudulent as well. Moreover, the manufacturer appears to be more profitable than it otherwise is. Thus, tax reduction can be an incentive for private companies to manipulate earnings.

***Charles R. Lundelius, Jr., CPA/ABV, is Senior** Managing Director of the Securities Litigation Group of FTI Consulting, Inc., Washington, D.C and is the author of the recently published* Financial Reporting Fraud: A Practical Guide to Detection and Internal Control. *His book is an AICPA publication priced at $49 for AICPA members; $61.25 for nonmembers. To obtain a copy, visit www.CPA2Biz.com or call 1-888-777-7077. Ask for product number 029879.*

Special Committee Formed to Enhance Business Reporting

A special committee aims to help improve the quality and transparency of business information used in decision making.

CPAs in public practice, as well as those who serve in the accounting or finance functions for their companies, now face a myriad of reporting responsibilities. In response to the CPA's increased role and its associated value to the public, a new committee was approved by the AICPA Board of Directors in December 2002 to explore how to enhance the delivery and content of business-related information. Chairing this effort for approximately a two-year initial term is Mike Starr, U.S. managing partner of strategic services for Grant Thornton LLP.

Committee initiatives

The Special Committee's mission is to establish a collaborative with investors, creditors, analysts, regulatory bodies, standards-setters, corporations, accounting firms, and other stakeholders to improve the quality and transparency of information used for decision-making. The conceptual framework for enhanced business reporting is based on five fundamental elements whose goals are to:

- Enable stakeholders to see an entity more through the eyes of management.
- Allow for customization to meet the needs of individual stakeholders.
- Address public demands for corporate accountability.
- Make information available online and real- or near real-time.
- Provide assurance to close the expectation gap.

The five fundamental elements of enhanced business reporting are:

1. *Systems reliability.* Successful entities are proactive in their assessment and management of information technology related risks. These organizations understand the competitive advantage in protecting the completeness and accuracy of data, guarding against the inappropriate access to systems and data, and ensuring the availability of systems to users. Enhanced business reporting envisions providing assurance (potentially on a continuous basis) on systems reliability and data integrity to enhance the level of stakeholder trust in information provided.
2. *Information dissemination.* Technology opens an array of opportunities to provide stakeholders with an almost infinite number of alternative displays of business information. The information needs of large and small equity investors, creditors, those interested in nonfinancial performance measures, and people interested in environmental issues vary widely. Extensible Business Reporting Language (XBRL), a standard for disseminating information, now provides a technology that enables entities to provide online, globally accessible information that can be customized to meet the special needs of disparate stakeholder groups.
3. *Financial and nonfinancial information.* The core of any reporting model will continue to be financial information based on generally accepted accounting principles (GAAP) and Securities and Exchange Commission (SEC) reporting requirements. However, most, if not all, business entities have identified critical internal financial and nonfinancial measures to more completely monitor performance. The inclusion of a wide range of financial and nonfinancial performance measures in business reporting will enable stakeholders to see an entity more through the eyes of management. This more transparent disclosure will lead to better understanding of management's objectives as well as the risks and opportunities associated with both equity and debt.
4. *Corporate accountability.* The catastrophic financial reporting failures of 2001 and the enactment of the Sarbanes-Oxley Act have increased public focus on the adherence of corporations to the highest standards of ethical behavior. The Special Committee will promote the reporting of corporate accountability data, including information on environmental, health, safety, and social responsibilities; corporate governance; privacy requirements; and enterprise risk management.
5. *Understandable disclosures.* Disclosure documents need to be written in plain English so that investors can fully understand information being provided and any related requirements.

Businesses and the users of their reported financial information do not want the same set of data in every situation, and today's stakeholders want data on demand rather than out-of-date, periodic information. Investors and creditors seek customized electronic reports that allow them to drill down to access more detailed information as needed. Even though today's business reporting is built on a solid foundation, this process is incomplete because of rising marketplace demands for more relevant, up-to-the-minute information.

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Update

CPA Exam To Be Computerized!

The Institute announced recently that the CPA exam has been updated to reflect the changing demands on the profession. As of April 5, 2004, the CPA exam will be computer-based and offered year-round, two out of every three months, at more than 300 test centers across the United States. The redesigned test emphasizes technology and general business knowledge and takes a broader approach to testing candidates' understanding of auditing concepts. In addition, the test will assess research and analysis skills. The new format is 14 hours long (1.5 hours shorter than the paper exam) and has four sections, namely, Auditing & Attestation, Financial Accounting & Reporting, Regulation, and Business Environments & Concepts (BEC). BEC is new and will focus on candidates' general business knowledge. All CPA candidates prepared and approved to take the April test are highly encouraged to do so. The new format draws on existing computer skills and more accurately replicates tasks performed by entry-level CPAs. Credits from the paper exam will transfer to the new format. For more information on the new CPA exam, visit **http://www.aicpa.org/pubs/jofa/sep2003/special.htm** to read a complete set of Q&A.

PCPS Announces New Chair

PCPS is pleased to announce that Rich Caturano will be the new chair of the PCPS Executive Committee. One of *Accounting Today's* "Top 100 Most Influential People," Rich has been deeply involved in both PCPS's activities, chairing the task force that launched the incredibly successful PCPS/TSCPA National MAP Survey. He also chaired the committee that planned the Practitioners' Symposium in 2003, one of the best ever. He is a tireless advocate, who has worked on the grassroots level in Massachusetts to prevent cascade effects of the Sarbanes-Oxley Act there and educate his peers about the Act's impact. As PCPS looks forward to Rich's leadership, it is also time to thank Bill Balhoff, the outgoing chair. Under Bill's guidance, PCPS has reached new heights, providing unprecedented resources and advocacy for small firms. PCPS wishes him the best in all future endeavors.

TIC Meeting Reminder

On November 13 and 14, TIC will be meeting in Washington, DC. All CPAs are invited to attend TIC meetings, which offer local practitioners the chance to provide their unique perspectives in the standard-setting process. Contact Linda Volkert, TIC Staff Liaison, at the AICPA at (212) 596-6040, to learn more.

Did You Know?

All PCPS members who participated in the 2003 PCPS/TSCPA National MAP Survey are entitled to a free, customized PDF report as well as access to an online tool, which will allow you to format and search the data from more than 3,300 participants in a manner that best suits your firms' needs. For nonparticipating PCPS member firms, the 2002 National Results are available as a member benefit that can be accessed by visiting **www.pcps.org** and click on the 2003 PCPS/TSCPA National MAP Survey logo on the left side of the screen.

FYI

PCPS, an alliance of the AICPA, represents more than 6,000 local and regional CPA firms. The goal of PCPS is to provide member firms with up-to-date information, advocacy, and solutions to challenges facing their firms and the profession. Please call 1-800-CPA-FIRM for more information.

Readers Respond

I am no authority on estate planning using FLPs and LLCs but I have used these vehicles in helping clients plan their estates for the future. I feel that the title "FLPs and LLCs At Risk" (September 2003) is very misleading, possibly on purpose, and I take offense at this type of editorial license. The basic premise of the cases related to "bad" FLPs and LLCs is that the entities were poorly designed and the operation of the entity was flawed from the outset. I don't feel that even one of the cases referred to in the article was properly designed or operated.

Some of my clients formed these planning vehicles a number of years ago and have operated them based upon a sound understanding of the rules that they have to play by in order for the entity to be respected by the Internal Revenue Service and the courts. I feel that the headline for your article should have more properly reflected the substance of the article; that is, improper implementation of a tax planning entity will often result in undesired results.

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Interpretations of AR Section 100 on Compilation and Review Issued

The Accounting and Review Services Committee has issued the following Interpretations of Statement on Standards for Accounting and Review Services (SSARS) No. 1, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2, AR sec. 100):

- "Reports on Specified Elements, Accounts, or Items of a Financial Statement – Revised"
- "Reference to the County of Origin in a Review or Compilation Report"
- "Omission of the Display of Comprehensive Income in a Compilation"

The Accounting and Review Services Committee encourages practitioners to incorporate the guidance contained in the interpretations as soon as practicable. The Alert is currently available on the AICPA's Web site at: **http://www.aicpa.org/download/members/div/auditstd/ssars_interp.pdf**

Please contact Michael Glynn at 1-212-596-6250 or at mglynn@aicpa.org if you have any questions.

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